

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:NER:MAN:TL-N-3550-99
OMendiburt/LLDavidow

date:

to: District Director, Manhattan District
Attn: Dennis Zuckerbrot, Case Manager

from: District Counsel, New York CC:NER:MAN

subject:

I.R.C. § 6402(b) Credit Elect Issue

I.R.C. § 6621(d) Interest Netting Issue

UIL Numbers: 6402.01-02 and 6621.00-00

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We have been asked for assistance to determine the period during which interest accrues on the deficiencies of the taxpayer for the taxable years ended December 31, [REDACTED], December 31, [REDACTED], and December 31, [REDACTED]. In addition, we have been asked for advice on the applicability of interest netting under I.R.C. § 6621(d). The advice rendered in this memorandum is conditioned on the accuracy of the facts provided to us.

Facts:Application of Overpayment for [REDACTED]

[REDACTED] (the "taxpayer") filed its consolidated Federal income tax return on or about [REDACTED],¹ reflecting an overpayment of approximately \$ [REDACTED]. On this tax return, the taxpayer requested that the Service apply the entire overpayment to its [REDACTED] estimated tax.

Excluding the [REDACTED] overpayment, the taxpayer made estimated tax payments for [REDACTED] of approximately \$ [REDACTED], \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED] for the first, second, third, and fourth installments, respectively. On the Form 2220 (Underpayment of Estimated Tax by Corporations) attached to the taxpayer's [REDACTED] Federal income tax return, the taxpayer treated the \$ [REDACTED] overpayment as having been applied to its third installment of estimated taxes. Absent the application of the \$ [REDACTED] overpayment to its [REDACTED] estimated taxes, the taxpayer would have been liable for an addition to tax for failure to pay estimated tax under I.R.C. § 6655.

On [REDACTED], the taxpayer was assessed a deficiency of \$ [REDACTED] for its [REDACTED] tax year and corresponding interest of \$ [REDACTED]. A portion of this interest is the subject of this memorandum. The Service began computing the interest on the deficiency on [REDACTED], the due date of the taxpayer's first estimated tax installment for [REDACTED]. According to the taxpayer, interest should have started to accrue on [REDACTED], the unextended due date of its [REDACTED] tax return.

Application of Overpayment for [REDACTED]

The taxpayer filed its [REDACTED] consolidated Federal income tax return on or about [REDACTED], reflecting an overpayment of approximately \$ [REDACTED]. On this tax return, the taxpayer requested that the Service apply the entire overpayment to its [REDACTED] estimated tax. A [REDACTED] overpayment from [REDACTED], of

¹The taxpayer is the parent of an affiliated group of corporations that has elected to file consolidated Federal income tax returns. The taxpayer has a calendar year tax period. The taxpayer timely filed requests to extend the time to file its Federal income tax returns on [REDACTED] and [REDACTED] ([REDACTED] fell on a Saturday), respectively. The taxpayer timely filed Federal income tax returns for tax years [REDACTED], [REDACTED], and [REDACTED] pursuant to the extensions.

approximately \$ [REDACTED] was also credited to the taxpayer's [REDACTED] estimated tax.²

Excluding the overpayment, the taxpayer made estimated tax payments for [REDACTED] of approximately \$ [REDACTED], \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED] for the first, second, third, and fourth installments, respectively. On the Form 2220 attached to the taxpayer's [REDACTED] Federal tax return, the taxpayer's third installment was shown as approximately \$ [REDACTED], the sum of the \$ [REDACTED] estimated tax payment, the \$ [REDACTED] that had been credited from the [REDACTED] overpayment, and the \$ [REDACTED] that had been credited from the [REDACTED] overpayment. Absent the application of the \$ [REDACTED] overpayment to its [REDACTED] estimated taxes, the taxpayer would have been liable for an addition to tax for failure to pay estimated tax under I.R.C. § 6655.

On [REDACTED], the taxpayer was assessed a deficiency of \$ [REDACTED] for its [REDACTED] tax year and corresponding interest of \$ [REDACTED]. A portion of this interest is the subject of this memorandum. The Service computed the interest on the portion of the tax deficiency equal to the credit elect beginning on [REDACTED], the due date of the first estimated tax installment for the [REDACTED] tax year. The interest on the balance of the tax liability began accruing on [REDACTED], the unextended due date of its [REDACTED] tax return. The taxpayer argues that the interest on the portion of the tax deficiency equal to the credit elect should start accruing on [REDACTED], the date on which the credit elect was applied to its third estimated tax installment for [REDACTED]. The taxpayer agrees with the Service's assessment of interest on the portion of the tax liability in excess of the credit elect.

Application of Overpayment for [REDACTED]

The taxpayer filed its [REDACTED] consolidated Federal income tax return on or about [REDACTED], reflecting an overpayment of \$ [REDACTED]. On this tax return, the taxpayer requested that the Service apply the entire overpayment to its [REDACTED] estimated tax.

Other than the overpayment, the taxpayer made estimated tax payments for [REDACTED] of \$ [REDACTED], \$ [REDACTED], \$ [REDACTED],

² [REDACTED] was purchased by the taxpayer in [REDACTED]. [REDACTED] was one of the subsidiaries included in the consolidated return that the taxpayer filed for [REDACTED].

and \$ [REDACTED] for the first, second, third, and fourth installments, respectively. On the Form 2220 attached to the taxpayer's [REDACTED] Federal income tax return, its third installment included the [REDACTED] overpayment. Absent the application of the \$ [REDACTED] overpayment to its [REDACTED] estimated taxes, the taxpayer would have been liable for an addition to tax for failure to pay estimated tax under I.R.C. § 6655. The taxpayer's [REDACTED] Form 1120 reflected an overpayment of \$ [REDACTED] which it elected to apply to its [REDACTED] estimated tax payments.

On [REDACTED], the taxpayer was assessed a deficiency for [REDACTED] of approximately \$ [REDACTED] and corresponding interest of \$ [REDACTED]. A portion of this interest is the subject of this memorandum. The Service started accruing interest on the deficiency on [REDACTED], the due date of the first estimated tax installment for [REDACTED]. The taxpayer argues that interest should begin accruing on [REDACTED] the unextended due date of its [REDACTED] Federal income tax return.

Issues:

1. On what date does interest begin to accrue on the tax deficiencies for [REDACTED], [REDACTED], and [REDACTED]?
2. Is the taxpayer entitled to interest netting during the period [REDACTED] through [REDACTED] to the extent the underpayments for [REDACTED] and [REDACTED] offset the [REDACTED] overpayment?

Analysis:

1. Credit Elect Issue

In general, the Government is entitled to interest on a deficiency in tax for the period during which the tax was due and unpaid. I.R.C. § 6601(a); *Avon Products v. United States*, 588 F.2d 342 (2d Cir. 1978). If a deficiency in tax is determined after the taxpayer elected to credit a return overpayment against its estimated tax liability for the next succeeding year, interest will begin to accrue on the amount of the deficiency equal to the amount of the return overpayment as of the effective date of the credit elect. H.R. Rep. No. 98-432 (Part I), 98th Cong., 1st Sess. 190 (Oct. 21, 1983); see also, Rev. Rul. 88-98, 1988-2 C.B. 356. Section 413 of the Tax Reform Act of 1984 provides that overpayments of tax will be credited against the estimated income tax for the next succeeding year with full

regard to Revenue Ruling 77-475, 1977-2 C.B. 476.³ Pub. L. No. 98-369, 98 Stat. 494. Revenue Ruling 77-475, in pertinent part, provides:

If an overpayment of income tax for a taxable year occurs on or before the due date of the first installment of estimated tax for the succeeding taxable year, the overpayment is available for credit against any installment of estimated tax for such succeeding taxable year and will be credited in accordance with the taxpayer's election.

1977-2 C.B. at 476 (emphasis added). Accordingly, interest on the portion of the deficiency in the prior year equal to the credit elect begins to accrue on the due date of the installment of estimated tax for the succeeding taxable year against which the overpayment was credited in accordance with the taxpayer's designation. H.R. Rep. No. 98-432 (Part I), 98th Cong., 1st Sess. 190 (Oct. 21, 1983); see also Rev. Rul. 88-98, 1988-2 C.B. 356. However, the deficiency becomes both due and unpaid, and thus triggers the running of interest on that deficiency, only when the overpayment balance, after the application to the succeeding tax year's estimated taxes, is less than the deficiency for the overpayment year.

Pursuant to Revenue Ruling 84-58, 1984-1 C.B. 254, which modified Revenue Ruling 77-475, the Service will generally credit a reported overpayment of tax against the taxpayer's first installment of estimated income tax for the succeeding tax year unless the taxpayer attached a statement to its return that designated otherwise. However, in *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), the Court of Federal Claims concluded that the assumption behind the default rule in Revenue Ruling 84-58 was that the taxpayer had underpaid its first installment of estimated tax for the succeeding tax year. Thus, a return overpayment will not be credited for interest purposes to an installment of estimated tax due prior to the

³ In 1983, the Service revoked Revenue Ruling 77-475. Rev. Rul. 83-111, 1983-2 C.B. 245. However, in response to public criticism and expected Congressional action, the Service promulgated Revenue Ruling 84-58, 1984-1 C.B. 254, which reinstated and modified Revenue Ruling 77-475 on March 30, 1984 by ruling that the Service should apply the overpayment to the first installment of estimated tax for the succeeding taxable year.

filing of the prior year's return if the taxpayer did not designate the particular installment of estimated tax against which to apply the return overpayment and if the installments of estimated tax due prior to the filing of the prior year's return were fully paid without the application of the return overpayment. *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996). The Service has acquiesced in the *May Department Stores* decision. *May Department Stores Co. v. United States*, AOD CC-1997-008 (Aug. 4, 1997).⁴

In light of the *May Department Stores* decision, the Service has reconsidered the manner in which interest on a subsequently determined deficiency is computed under I.R.C. § 6601(a) when the taxpayer makes an election to apply an overpayment to the succeeding year's estimated taxes. AOD CC-1997-008 (Aug. 4, 1997). When a taxpayer elects to apply an overpayment to the succeeding year's estimated taxes, the overpayment is applied to unpaid installments of estimated tax due on or after the date(s) on which the overpayment arose, in the order in which they are required to be paid to avoid an addition to tax for failure to pay estimated tax under I.R.C. § 6655 with respect to such year.

The date on which the overpayment becomes a payment on account of the succeeding year's estimated tax determines the date on which the prior year's tax became unpaid for purposes of I.R.C. § 6601(a). Prior to that date the Government has had the use of the funds with respect to the prior year's tax, and no interest is payable on the deficiency equal to the portion of the overpayment that is the subject of the taxpayer's election. See I.R.C. § 6402(b); Treasury Reg. § 301.6402-3(a)(5) and §

⁴ The *May Department Stores* action on decision provides:

[F]or deficiency interest purposes, where a taxpayer does not initially designate a reported overpayment to satisfy a particular installment [of estimated tax] for the following year, and crediting of the return overpayment is not necessary to fully pay an installment of estimated tax due prior to the filing of the prior year's return, the reported overpayment will not be deemed to be credited to an installment of estimated tax due prior to the filing of the prior year's return.

May Department Stores Co. v. United States, AOD CC-1997-008 (Aug. 4, 1997).

301.6611-1(h)(2)(vii). Interest should be charged from the point the prior year's tax is both due and unpaid. *May Department Stores Co. v. United States*, 36 Fed. Cl. 680 (1996), acq. AOD CC-1997-008 (Aug. 4, 1997); *Avon Products, Inc. v. United States*, 588 F.2d 342 (2d Cir. 1978); Rev. Rul. 88-98, 1988-2 C.B. 356. Revenue Ruling 84-58 requires the taxpayer to attach a statement to its return, designating the installment of estimated tax against which the overpayment should be applied.

In *Sequa Corporation v. United States*, 97-1 USTC ¶ 50,317 (S.D.N.Y. 1996), the taxpayer had elected to apply its 1990 overpayment to its 1991 estimated tax payments. Subsequently, the taxpayer filed its 1991 tax return showing that the taxpayer had made sufficient estimated tax payments (excluding the overpayment) to satisfy the subsequent year tax liability. Based on the facts before it, the Court opined that the interest on a subsequent tax assessment, up to the amount of the overpayment, begins to accrue on the due date of the subsequent year tax return. The Court reasoned that the overpayment was not "effective" as an estimated tax payment for the subsequent year and that the Service never lost the "use of the money."

For [REDACTED], to the extent that the deficiency of \$ [REDACTED] is equal to or less than the portion of the \$ [REDACTED] overpayment that was not needed to avoid the estimated tax penalty for [REDACTED] the interest on the deficiency will begin to accrue on [REDACTED]. If the taxpayer needed the entire \$ [REDACTED] or an amount greater than \$ [REDACTED] (\$ [REDACTED] minus \$ [REDACTED]) to be applied to its [REDACTED] estimated tax payments to avoid the failure to pay estimated tax penalty, then interest on the entire deficiency or on the difference between the amount needed to be applied and \$ [REDACTED], respectively, would begin to accrue on [REDACTED].

For [REDACTED], the interest on the deficiency should begin to accrue on [REDACTED] to the extent of the credit elect (\$ [REDACTED]) pursuant to the holding in *May Department Stores*. The interest on the balance of the deficiency (\$ [REDACTED] minus \$ [REDACTED]) should start accruing on [REDACTED] the unextended due date of The taxpayer's [REDACTED] tax return.

For [REDACTED], like [REDACTED], interest on the deficiency of \$ [REDACTED] will begin accruing on [REDACTED] provided that \$ [REDACTED] of the \$ [REDACTED] overpayment was not needed to avoid the estimated tax penalty under I.R.C. § 6655.

2. Interest Netting Issue

Pursuant to I.R.C. § 6621(d) as enacted by P.L. 105-206, § 3301(a) on July 22, 1998, "to the extent that, for any period, interest is payable ... and allowable ... on equivalent underpayments and overpayments by the same taxpayer of tax imposed by this title, the net rate of interest under this section on such amounts shall be zero for such period." Accordingly, for the zero rate of interest to apply, the taxpayer must have an underpayment and overpayment for overlapping periods.

During the period at issue, [REDACTED] through [REDACTED], the taxpayer owed deficiencies for the tax years [REDACTED] and [REDACTED]. The taxpayer argues that the [REDACTED] overpayment overlaps these underpayments. Treas. Reg. § 301.6611-1(b) defines the dates of overpayment of any tax as the date of payment of the "first amount which (when added to previous payments) is in excess of the tax liability (including interest, addition to the tax, or additional amount)." However, the regulations also state that if the taxpayer elects to apply its overpayment to the succeeding year's estimated tax payments, "no interest shall be allowed on such portion of the overpayment credited." Treas. Reg. § 301.6611-1(h)(2)(vii). Since the taxpayer applied its [REDACTED] overpayment to its [REDACTED] estimated tax payments, interest is not allowable under Treas. Reg. § 301.6611-1(h)(2)(vii). Thus, the taxpayer has no overpayment for [REDACTED] during the period at issue to offset against the underpayments for [REDACTED] and [REDACTED].

Conclusion:

1. Based on the foregoing, we recommend that you allow the refund of interest requested by the taxpayer for each of the years. Interest on the [REDACTED] additional assessment will begin to accrue on [REDACTED], provided that the conditions discussed above are satisfied. Interest on the [REDACTED] additional tax assessment will begin to accrue on [REDACTED] to the extent of the overpayment. Interest on the balance of the deficiency will begin to accrue on [REDACTED]. Interest on the [REDACTED] additional tax assessment will begin to accrue on [REDACTED], provided that the conditions discussed above are satisfied.

2. We recommend that you disallow the interest netting requested by the taxpayer for the period [REDACTED] through [REDACTED].

[REDACTED]

If you have any questions regarding this matter, please contact Oleida Mendiburt of our office at (212) 264-5473, Ext. 214.

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